Washington's Impasse and You

The budget impasse in Washington forced the federal government to shutter many of its operations. The immediate impact on investment markets was ambiguous.

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The partial shutdown of the federal government appears to have put more than 800,000 federal employees (plus uncounted contractors) out of work,[1] at least temporarily. In addition, it shuttered popular tourist destinations, suspended many new pharmaceutical and medical device trials, stalled passport processing, and caused other scattered disruptions in the economy. But law enforcement and security services, coast guard, air traffic control, and other public safety functions continue. Social Security and Medicare payments are proceeding without interruption, so is medically necessary care at federally funded hospitals and clinics.

On Wall Street, fear of the impending closures sparked a 3% slide in the S&P 500 in late September.[2] But that decline seems to have reached its nadir on the eve of the shutdown itself. Trading through October 3 was volatile but mostly without any sustained direction; the S&P 500 ended the day with little net change from its September 30 close.

Treasury bonds, meanwhile, appeared to have actually received a small boost in the run-up to the shutdown, a boost that carried over into the immediate aftermath of the shutdown. The benchmark yield on the 10-year Treasury bond edged lower from mid-September to early October, creating modest gains in the market values of typical existing 10-year bonds.[3]

A Measured Impact on the Economy

Attempting to assess the significance of the federal shutdown may open the way for hefty doses of political positioning. However, there is a clear economic impact from removing hundreds of thousands of workers and billions of dollars' worth of spending from the economy each week, and it can be readily estimated. The research firm IHS projected that the shutdown would remove $300 million in spending from the economy every day it continues. Standard & Poor's Ratings Services concluded that the shutdown could shave approximately three-tenths of a percentage point off the expected real GDP growth rate for each week it drags on. That assumes that the economy follows the same track as it did during the mid-1990s, which was the last time that there were significant interruptions in federal spending. But the economy is much weaker now than it was then, S&P cautioned, so the impact of the shutdown this time could be more severe.

The Debt Ceiling -- An Unknown on the Horizon

With no clear end-game in sight for the current budget impasse, Congress faces another intense debate in mid-October when the Treasury bumps up against the limits of its current credit lines; in other words, it hits the debt ceiling. No one can say for sure exactly when the Treasury will hit the limit of its authority to borrow money. The Treasury's own estimate is October 17, but if the shutdown continues, then the crisis date might slide out as the government spends less than expected. Nor can anyone say for certain what would happen if the Treasury *does* hit the ceiling.

As things stand in the shutdown era, the government devotes existing cash flows to finance all payments on existing debts, continue Social Security benefits and other entitlements, and use whatever cash might be left to pay for essential safety and health services. If hitting the debt ceiling means an end to all borrowing, then cash resources will become severely constrained and some kind of default could become inevitable, if not on debt service, then on Social Security payments or public safety commitments. Default in any of those areas would be unprecedented, but Standard & Poor's Ratings Services believes it would also be unlikely. In a September 30 statement, the firm said it was maintaining a stable outlook on Treasury debt, which means S&P estimates that the chance of any serious credit event in the next two years is currently only one in three.

For investors, it may be helpful to recall that past shutdowns are now mostly minor footnotes in economic and financial history. Past performance may not assure future results, but long-term investment strategies are typically meant to help you avoid precipitous action, because hurried trading in the face of market volatility may lock in losses as easily as avert them.

[1]Source: Impact of a Government Shutdown, *The Washington Post*, retrieved on October 3, 2013.

[2]Source: Standard & Poor's. The S&P 500 reached an intraday high of 1729.44 on September 18, 2013, and then slid to an intraday low of 1674.99 on September 30, 2013. Investors cannot invest directly in any index. Past performance does not assure future results.

[3]Sources: The Federal Reserve Board's H.15 report and Standard & Poor's. The constant maturity yield on 10-year Treasury bonds on September 18, 2013, was 2.69% and on September 30, 2013, 2.64%. The market yield on 10-year bonds on October 3, 2013, was 2.61%. As a result, the market value of a 10-year bond that had been issued at face value with the indicated yield and semiannual interest payments on September 18 could have increased by approximately $306 by October 3. Bonds reflecting other payment scenarios could vary in value somewhat from the base case.